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In The

Supreme Court of the United States

OCTOBER TERM, 1978

No. 78-309

TOUCHE ROSS & Co.,

Petitioner,

—against—

EDWARD S. REDINGTON, as Trustee for the liquidation of the business of Weis Securities, Inc., and SECURITIES INVESTOR PROTECTION CORPORATION,

Respondents.

BRIEF OF RESPONDENT EDWARD S. REDINGTON IN OPPOSITION TO THE PETITION FOR A WRIT OF CERTIORARI

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Preliminary Statement

This brief is submitted by Edward S. Redington, Esq., (the "Trustee") in opposition to the petition of Touche Ross & Co. ("Touche Ross") for a writ of certiorari to review the judgment of the United States Court of Appeals for the Second Circuit entered on April 21, 1978. The Trustee was appointed by order of the United States District Court for the Southern District of New York to liquidate the business of Weis Securities, Inc. ("Weis") pursuant to the Securities Investor Protection Act of 1970, 15

U.S.C. §§ 78aaa *et seq.* ("SIPA" or the "1970 Act").[1] The Trustee is also submitting contemporaneously herewith a cross-petition for certiorari requesting that this Court review or remand for consideration by the Second Circuit two additional issues which were raised but not decided below.

A separate brief in opposition to Touche Ross' petition is being submitted on behalf of the Trustee's co-respondent and co-plaintiff below, the Securities Investor Protection Corporation ("SIPC"). The reasons why a writ of certiorari should not be issued to review the decision of the Second Circuit that a private right of action should be implied under Section 17 of the Securities Exchange Act of 1934[2] are well stated in that brief and need not be repeated here. The Trustee's brief sets forth additional reasons why this narrow issue is neither ripe nor appropriate for review by this Court and why the Court should not review the Second Circuit's even narrower decision that the Trustee has standing to sue as bailee of property entrusted to Weis by the relatively few customers whose claims have not been satisfied in the course of the liquidation.

Additional Question Presented

In addition to the questions stated in SIPC's brief, the following question is raised by Touche Ross' petition:

> Whether the Trustee of a brokerage house in liquidation under SIPA has standing as a bailee to sue

1. After this action was commenced, the Securities Investor Protection Act was amended in certain respects in 1978. Pub. L. No. 95-283, 92 Stat. 249 (1978). Where reference is made to the Act as it existed before the amendments it will be called the "1970 Act".

2. 15 U.S.C. §§ 78a *et seq.* (hereinafter the "Exchange Act"). References to the Exchange Act are to that Act as it existed in 1973. The Act underwent immaterial amendments in 1975. Publ. L. No. 94-29, 89 Stat. 97 (1975).

> third parties in the interests of customers with unsatisfied claims who entrusted "customer property" to the debtor which is not considered part of the debtor's general assets and which the Trustee has special duties to marshal and return?

Counter-Statement Of The Case

From 1969 to the date of its forced liquidation in May 1973, Weis engaged Touche Ross as its accountant and auditor for various purposes, including especially the preparation, audit and certification of reports complying with the requirements of SEC Rule 17a-5, 17 C.F.R. § 240.17a-5 ("Rule 17a-5")[3] as well as with generally accepted accounting principles and generally accepted auditing standards. (Cplt ¶ 17.)[4] Among the series of audits and other accounting services which Touche Ross undertook to perform were those preceding Touche Ross' certification of Weis' Answers to Financial Questionnaire and other documents for Weis' fiscal year ended "as at May 26, 1972." Some of these documents were required to be filed with regulatory authorities by Section 17 and the rules and regulations thereunder. (Cplt ¶¶ 19-23.)

Because of the reliance placed on Rule 17a-5 audits by regulatory authorities, Rule 17a-5 has always required an accountant to make specific representations and certifications about the scope of its audit and the nature of its opinion with respect to a broker-dealer's statement of financial condition, especially as the accountant's examination related to a broker's compliance with rules adopted for the protection of customers. At the time of Weis' audit, for example, Subparagraph 17a-5(g)(2) expressly

3. The Rule as it existed at the time of the audit is set forth at pages 62a-70a of the appendix to Touche Ross' petition. Numerals followed by the letter "a" refer to the pages of that appendix.

4. Reference to "Cplt " are to paragraphs of the complaint. The complaint is contained in the appendix to SIPC's brief in opposition to Touche Ross' petition.

required the accountant to describe the scope of the audit made, whether the audit was made in accordance with generally accepted accounting principles and whether any procedures deemed necessary by the accountant were omitted. The subparagraph concluded by warning that no authority could be implied for omitting any procedures which would normally be employed for the purposes of the certifications required by the rule. (67a.) Subparagraph (h) required the accountant to "state clearly" the accountant's opinion "with respect to the financial statement covered by the certificate and the accounting principles and practices reflected therein." (68a.) Subparagraph (i) placed a duty on the accountant to flag potential trouble spots by requiring him to state "specifically and clearly" any "exception" he may have to "[a]ny matters" otherwise covered by his opinion. (68a.)

At the conclusion of the audit of Weis "as at May 26, 1972" Touche Ross signed opinion letters addressed to Weis' board of directors in which it falsely stated that it had performed all steps required by Rule 17a-5 and certified without reservation of any kind—and without any real basis in fact—the reliability both of Weis' financial and income statements and of its internal system of accounting control. (Cplt ¶¶ 24, 28.)

Despite the representations in the Touche Ross opinions, the report audited and certified by Touche Ross proved in fact to be materially false and misleading in many respects. Far from being subject to an adequate system of internal control, the Weis records had been manipulated by a small cadre of Weis officers and financial personnel[5] to disguise substantial operating losses and an unsatisfactory and rapidly deteriorating net capital ratio and financial position. For example, the income statements reflected an

5. The five Weis employees involved were indicted and sentenced for false financial reporting.

ostensible pre-tax profit of $1,700,000 when Weis had in fact lost at least $1,500,000; all of the reports misstated Weis' net worth and net capital position by substantial amounts. (Cplt ¶¶ 10, 29-31.)

Because Touche Ross gave Weis' financial reporting system a clean bill of health and failed to disclose the irregularities in its books and records, remedial action by Weis' board of directors and regulatory authorities that could have diminished or averted the losses suffered by customers and others in the Weis liquidation could not be taken. (Cplt ¶¶ 11-12, 31.) The deficiencies in Touche Ross' audit are thus alleged to have been the proximate cause of a SIPA liquidation in which the Trustee has been unable to make all of Weis' customers and creditors whole.

After a lengthy investigation by the Trustee under Section 167 of the Bankruptcy Act (11 U.S.C. § 567) (which included subpoenaing and reviewing the work papers prepared by Touche Ross in its 1972 audit) the Trustee and SIPC filed the complaint in this action in April 1976. Essentially, both plaintiff's allege that Touche Ross' 1972 audit of Weis was negligent, if not grossly negligent and reckless, and that Touche Ross breached specific duties to each plaintiff which it voluntarily assumed under Section 17 of the Exchange Act and under various principles of common law.

In his section of the complaint (Cplt ¶¶ 32-49) the Trustee claims that Touche Ross' false certifications and acts of misfeasance breached duties owed separately to Weis as the party which contracted for auditing and accounting services, as well as to customers who were the intended beneficiaries of the financial responsibility rules and the related auditing and certification requirements of Section 17 and Rule 17a-5. The Trustee's section of the complaint

also specifically alleges that Touche Ross' deficient auditing services caused damage to the customer property held by Weis as bailee in that they prevented Weis from preserving and safeguarding property which Weis held or should have held in trust for its customers. (Cplt ¶ 19a.)

After dismissal of the complaint by the District Court, the Court of Appeals sustained the Trustee's right to maintain an action under Section 17 as bailee of customer property on behalf of those customers of Weis whose claims could not be satisfied in full either from the customer property marshalled in the liquidation or through SIPC cash advances for missing property. The court also sustained SIPC's right to sue as subrogee of those customers whose claims were satisfied with unreimbursed cash advances. The court did not decide whether federal jurisdiction existed over the other, more substantial monetary claims asserted by the Trustee as successor to Weis for negligence, breach of contract and the like. Questions relating to the scope of this action, and to the nature of the remedy afforded SIPA trustees and SIPC under Section 17, were left for consideration by the District Court on remand.

I.

This Court Should Deny Touche Ross' Petition Because The Decision Of The Court Of Appeals That The Trustee Has Standing To Sue Is Not A Question Of National Importance, Is Not In Conflict With Decisions Of This Court And Is Supported By Well-Settled Principles Of Common Law.

In its decision the Second Circuit held that, as a bailee with special duties to marshal and return customer property which Weis had been required to keep separate from its own assets,[6] the Trustee had standing to maintain this action against Touche Ross for those customer claims which have not been satisfied in the liquidation either by the return of customer property or through SIPC cash advances. The Second Circuit's decision on this issue is entirely consistent with well-settled, centuries-old principles regarding the standing of bailees to sue for loss of bailed property and therefore provides no basis whatsoever upon which to issue a writ of certiorari in this case.

Touche Ross does not dispute that the Trustee is a bailee of Weis' customers under SIPA. Touche Ross simply requests that this Court review the Second Circuit's decision on a well-established point of bailment law which contradicts Touche Ross' position.

According to Touche Ross, the Trustee had no standing to sue on behalf of Weis' customers because a bailee may sue to vindicate only its own possessory interest as bailee and not the interests of its customer-bailors. (Certiorari Petition at 26.) Touche Ross' view of the law is incorrect. While it is true that a bailee's right to sue for injury to the

6. See the 1970 Act §§ 6(a)(1), 6(c)(2)(B), 6(c)(2)(C), 15 U.S.C. §§ 78fff(a)(1), 78fff(c)(2)(B), 78fff(c)(2)(C).

bailment entrusted to him is based on his special possessory interest in it the courts have long recognized the right of bailees to represent and requite the interests of bailors as well as their own possessory interests. In *The Beaconsfield,* 158 U.S. 303, 307 (1895), for example, this Court clearly indicated such a representative capacity of the bailee as follows:

> "The Beaconsfield having been sunk in a collision with the Britannia, her master and owner, as bailees of her cargo, proceeded against the Britannia for damages done to such cargo. This they had a right to do. *It is perfectly well settled that the carrier is so far the representative of the owner that he may sue in his own name, either at common law or in admiralty, for a trespass upon or injury to the property carried.*" (Emphasis added).

Accord, e.g., The W.C. Block, 71 F.2d 682, 683 (2d Cir.), *cert. denied,* 293 U.S. 579 (1934) ("For centuries it has been the settled rule, both at common law and in the admiralty, that either the bailor * * * or the bailee * * * might sue the tortfeasor for destruction of the bailed goods."); *Baldwin* v. *Hill,* 315 F.2d 738, 742 (6th Cir. 1963) ("With respect to third parties [a bailee] stands in the place of the owner [bailor]"); *Luckenbach Steamship Co.* v. *United States,* 315 F.2d 598, 605 (2d Cir. 1963); *Bradley* v. *St. Louis Terminal Warehouse Co.,* 189 F.2d 818, 823 (8th Cir. 1951). As the Court of Appeals noted (14a-15a) this principle is recognized in Rule 17(a) of the Federal Rules of Civil Procedure approved by this Court.

The premise of Touche Ross' argument—that two separate and severable interests emanate from a bailment and that the parties to the bailment can only bring actions to protect their own interests—also contradicts three elementary principles of bailment law: (1) either the bailor or

bailee can bring an action for the same injury to the bailed property, so that a recovery by one is a bar to a subsequent recovery by the other; (2) a bailee can sue for a full recovery beyond any direct harm to it and regardless of any liability it might have to the bailor; and (3) the bailee holds such recovery in trust for the bailor. As the New York Court of Appeals explained in *Rogers* v. *Atlantic, Gulf & Pacific Co.,* 213 N.Y. 246, 258, 107 N.E. 661, 664 (1915):

> "A bailee, though not liable to the bailor, may recover for the wrongful act of a third party resulting in the loss of, or injury to, the subject of the bailment. * * * If the bailee recovers, he holds the recovery as trustee for the bailor. A recovery by either bailor or bailee will bar an action by the other."

Contrary to Touche Ross' assertion, *Caplin* v. *Marine Midland Grace Trust Co.,* 406 U.S. 416 (1972), does not undercut the propriety of the Second Circuit's decision regarding the Trustee's standing. *Caplin* did not involve a SIPA Trustee with special duties to marshal and return to customers funds of "customer property" that are recognized as being separate from the debtor's own assets. In *Caplin,* no question of bailment law was presented. All *Caplin* held was that a Chapter X Trustee lacked standing to sue an indenture trustee for defaulting on its obligations to debenture holders.[7] No one ever contended that a cor-

7. Moreover, nowhere in *Caplin* did this Court indicate, as suggested by Touche Ross (Certiorari Petition at 27) that it would be possible to justify denying the Trustee standing as a bailee on the singular ground that Touche Ross could be subrogated to the rights of customers against the Weis Estate for damages paid to them as a result of Touche Ross' own misfeasance and negligence. The issue of subrogation was never reached by the Court even in the non-bailee context of *Caplin*. *See* 406 U.S. at 430. Touche

porate debtor (or its trustee) could be considered a bailee for its debenture holders.

Nothing in *Caplin* detracts from the long-settled rules which sanction actions by a bailee for injury to the subject of the bailment and which confer on the Trustee the right to sue in that capacity in this case. The Second Circuit properly decided that as bailee of customer property with special duties to marshal and collect that property, the Trustee may maintain this action on behalf of Weis' customer-bailors. There is no reason for this Court to disturb that decision.

Ross' argument that it would be entitled to such subrogation would be impossible to sustain. *German Bank* v. *United States*, 148 U.S. 573, 581 (1893). Indeed, although the majority of this Court in *Caplin* found it unnecessary to reach the subrogation issue in that case, the four dissenting Justices who did pass on the subrogation question (406 U.S. 339-40) pointed out that:

> "It is not imaginable that any court would ever hold that an indenture trustee, found culpably responsible for the default on debentures, would be subrogated with respect to funds which otherwise would go to innocent creditors or stockholders on the ground that paying money to them rather than to it would constitute unjust enrichment. A person 'who invokes the doctrine of subrogation must come into court with clean hands.' *German Bank* v. *United States*, 148 U.S. 573, 581." (406 U.S. at 440.)

Moreover, Touche Ross' attempt to extrapolate from the rationale of *Caplin* an argument that granting standing to the Trustee would be inconsistent with the rights of customers and lead to a multiplicity of litigation (Certiorari Petition at 27-28) also fails. As demonstrated above at pages 8-9, any recovery by the Trustee as bailee would be held in trust for customers and would be a bar to any further action by the customer against Touche Ross for the amount recovered by the Trustee.

II.

Touche Ross' Petition Should Be Denied Because Resolution Of The Issues Raised Will Not Have A Significant Impact On Litigation Under The Securities Laws In The Federal Courts.

In its petition Touche Ross also argues that certiorari should be granted because the implication of a private right of action under Section 17 will supposedly expose accountants making certifications under Rule 17a-5 to endless litigation by an indeterminate class of customers and that consequently the volume of litigation under the Exchange Act will be greatly expanded. (Certiorari Petition at 30-33.) This argument is echoed in the motion of the American Institute of Certified Public Accountants for leave to file an amicus brief in support of Touche Ross' petition. (Amicus Motion at 15.)

In its attempt to build a question of burning importance out of this issue Touche Ross has clearly overstated the case. The plain fact is that the prospective liability of accountants under Section 17 will arise only in exceptional situations which are similar to this case, and that even in those instances the accountant's liability would be limited to a small group of persons. As explained below, in the likely course of human events and under SIPA as recently amended, the class of potential plaintiffs would consist almost entirely of SIPC. Only in situations of exquisite rarity—where some customers cannot be made whole in a liquidation under the new SIPA—are suits by Trustees or individual customers even a theoretical possibility.[8]

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8. These situations, though rare, make it clearest that customers—those for whose benefit the accountant is required to certify that he has performed duties under Section 17—must have an effective remedy for non-performance of those duties. State law is based on rules of privity having nothing to do with federal regulation of the brokerage industry and cannot be looked to as a source of appropriate remedies. Section 27 of the Exchange Act (15 U.S.C. § 78aa), ignored in Touche Ross' petition, was designed by Congress for such situations.

The unusual conjunction of circumstances which gave rise to this litigation and under which an accountant's liability might arise in the future would require first, that a major brokerage house fail and be placed in liquidation; second, that the auditor breach its obligations under Section 17 to the customers of the brokerage house in a manner so egregious that effective remedial action becomes impossible (for example, as here, where Touche Ross is alleged to have failed to detect crude bookkeeping manipulations and acts of fraud and criminal conduct); and finally, that the collapse of the brokerage house be so complete that customer claims cannot be satisfied from property marshalled in the course of the liquidation.

This unhappy conjunction of circumstances is not an everyday event. It is the type of financial disaster which has occurred but rarely in our history, and for participation in which an accountant ought to anticipate liability. Weis, for example, is the only member of the New York Stock Exchange ever to be liquidated under SIPA.

Touche Ross' statistics on broker liquidations in the eight years since SIPA was enacted exaggerate what the future is likely to hold in store. Only a handful of the liquidations referred to by Touche Ross have occurred since 1973, and the amount of losses sustained by customers or even by SIPC in these post-1973 liquidations has not been substantial. *See* Securities Investor Protection Act Amendments of 1977, H.R. Rep. No. 95-746, 95th Cong. 1st Sess. 37, 38 (1977). As noted in the Senate Report of the SIPA amendments:

> "There have been 129 liquidation proceedings under SIPA since 1970, the great majority of those liquidations commenced in 1973 and earlier years. Because of better surveillance and other factors, the number of liquidations has been declining since that time."

Securities Investor Protection Act Amendments of 1978, S. Rep. No. 95-763, 95th Cong., 2d Sess. 5 (1978).

Because the circumstances that could give rise to a Section 17 action are so extraordinary, no cases involving Section 17(a) other than this one and *Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185 (1976), have apparently arisen under that section in the forty-four years of its existence. One hundred twenty-eight SIPA liquidations other than this one have taken place; they have apparently produced no actions under Section 17. The actions that Touche Ross points to are all suits arising out of this liquidation. These circumstances underscore the fact that the Weis liquidation and Touche Ross' potential liability with respect to it are *sui generis.* They are understandably a matter of concern to Touche Ross, but that does not imbue them with broad national significance.

Touche Ross' assessment of the impact of the Court of Appeals' decision ignores the fact that SIPA has recently been amended to increase the levels of protection for customers and to provide greater flexibility in satisfying customer claims than existed under the Act in effect at the time of the Weis liquidation. *See* H.R. Rep. No. 95-746 *supra,* at 39-40; Securities Investor Protection Act, as amended, Pub. L. No. 95-283, 92 Stat. 249 (1978). The effect of these changes is to make it extremely unlikely that individual customers will suffer appreciable loss in a brokerage house collapse.[9]

If there were to be other liquidations comparable to Weis, they would produce no flood of lawsuits. Waves of cus-

9. Even under the original Act, the total number of customers whose claims were not satisfied in full (and whose claims could therefore conceivably have led to a suit either by a SIPC trustee or an individual claimant) in 123 liquidations, including Weis, between 1970 and the first six months of 1977, was 163, and their claims totaled only $3 million. H. R. Rep. No. 95-746, *supra,* at 23, 40. The Weis liquidation accounts for a substantial portion of both figures. Had the increased amounts of SIPC cash advances established by the SIPA amendments been in effect, the number of customers with unsatisfied claims would have been reduced to 21, and their claims would have totaled $1 million. *Id.* at 40.

tomer-plaintiffs and SIPA Trustees are not about to inundate the nation's federal courthouses. Few if any customers will suffer a loss in future liquidations. Such liquidations would therefore be likely to produce, at most, one plaintiff—SIPC, an entity created by Congress and ultimately accountable to it. And of course in the real world even SIPC will have cause to become a plaintiff only in the rarest of circumstances.

Grant of certiorari would surely be ill-advised here where Touche Ross asks the Court to act at a time when many aspects of Section 17 and the newly-amended SIPA await further development. Even in this very case, the Section 17 issue may have only an illusory importance. In addition to his claim under Section 17, for example, the Trustee has alleged five other substantial claims under state and common law based on the same facts as his Section 17 claim. As to those claims, the Trustee has asserted that the District Court has independent jurisdiction as a Court of Bankruptcy. These jurisdictional issues are presently before this Court on the Trustee's cross-petition for certiorari. Should this Court or the Second Circuit on remand uphold the Trustee's position on these issues the practical importance and need for deciding the Section 17 question would largely have disappeared.

Conclusion

For the foregoing reasons, the petition by Touche Ross for a writ of certiorari should in all respects be denied.

Dated: September 22, 1978

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